



**Consultative Group to Assist the Poorest (CGAP)
Working Group on Savings Mobilization**

**RURAL BANK OF PANABO (RBP),
PHILIPPINES (CASE STUDY)**

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ABBREVIATIONS

ADB	Average Daily Balance
ASC	Accounting Standard Council
BMZ	Bundesministerium für wirtschaftliche Zusammenarbeit und Entwicklung
BOD	Board of Directors
BPI	Bank of the Philippine Islands
BSP	Bangko Sentral ng Pilipinas
BWTP	Banking with the Poor
CB	Central Bank
CDA	Cooperative Development Authority
CGAP	Consultative Group to Assist the Poorest
CLF	Countryside Loan Fund
FAO	Food and Agriculture Organization of the United Nations
GDP	Gross domestic product
GM	General Manager
GNP	Gross National Product
GSIS	Government Service Insurance System
GTZ	Deutsche Gesellschaft für Technische Zusammenarbeit
LBP	Landbank of the Philippines
MIS	Management Information System
NEDA	The National Economic and Development Authority
NGO	Non-governmental organization
PDIC	The Philippine's Deposit Insurance Corporation
PPP	Purchasing-Power Parity
PRC	Professional Regulation Commission
Ps	Peso
RBAP	Rural Bankers Association of the Philippines

RBP	Rural Bank of Panabo
RBRDF	Rural Bankers Research and Development Foundation
ROE	Return on equity
ROSCA	Rotating Savings and Credit Association
SBGFC	Small Business Guarantee and Finance Corporation
SEC	Securities and Exchange Commission
SFAS	Statement of Financial Accounting Standards
SHG	Self-help group
SMEC	Small or Medium Enterprise Credit
SSS	Social Security System
UCPB	United Coconut Planters Bank
UNDP	United Nations Development Programme

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1 CONTEXT

1.1 Macroeconomic context

Until the beginning of the financial crisis in the second half of 1997, the Republic of the Philippines was making progress towards recovering from the economic and political crises of the early 1980s, when low investment and savings rates caused the Philippines to lag drastically behind its dynamic Asian neighbors. An array of reform programs introduced since the mid-1980s, including measures for deregulation, privatization and price, trade and investment liberalization, helped to contribute to an economic turn-around. After slowly increasing growth rates between 1991-1995, real Gross National Product (GNP) grew by 5.4% in 1996 and by 5.3% in 1997. The inflation rate dropped from 20% in 1991 to only 8.1% in 1995. The average interest rate in the banking sector halved in a ten-year period from 28.2% in 1985, to 14.6% in 1995.

The encouraging economic recovery during the mid-1990s came to a halt in the last quarter of 1997, when the adverse effects of the Asian economic and financial crisis began to unfold in the Philippines. Gross domestic product (GDP) growth was negative in 1998 with -0.5%. The contraction was caused by the decline of construction and construction-related manufacturing by 9.5% and a drop by 6.6% in agricultural production.

In the past three decades, the service sector emerged from an initial share of 35% to a considerable 45% share in total GNP. An estimated half of the total labor force is employed in the agricultural sector, where growth rates have been either stagnant or declining. In the period 1975-1994, the share of the agricultural sector to total GNP declined from 30% to 22%. The situation further deteriorated when the El Niño phenomenon greatly devastated agriculture through a dry spell in 1998.

The per capita nominal GNP was US\$1,050 in 1995.¹ The average figure does not reveal the large rural-urban disparities related to the access of the rural people to services like health, safe water and sanitation. While the proportion of the population below the poverty line has decreased from 59% in 1961 to 36% in 1994, this rate of improvement in poverty alleviation is below the rates of other Southeast Asian countries like Indonesia, Thailand and Malaysia. The Government of the Philippines has identified 20 provinces as priority targets for its poverty alleviation program.²

1.2 Context of the financial sector

1.2.1 Role of the central bank

The *Bangko Sentral ng Pilipinas* (BSP) was established as an "independent central monetary authority" in 1949. The BSP's main responsibility is to formulate and implement policy in the

¹ Statistical data for the first section of this study came from (a) UNDP, Human Development Report 1998, (b) Worldbank, World Development Report 1996; (c) Asian Development Bank, <http://internotes.asiandevbank.org/notes/phi/PHINACT.htm> and d) National Economic and Development Authority, <http://www.neda.gov.ph>.

² The real GDP per capita income based on the Purchasing-Power Parity (PPP) allows a more accurate measure of national wealth and a comparison with other countries. Per-capita GDP (PPP) in 1995 for the Philippines was US\$2,762 compared to US\$3,971 for Indonesia, US\$7,742 for Thailand, US\$2,617 for Bolivia, US\$6,347 for Colombia and US\$565 for Mali.

areas of money, banking and credit. The primary objective is to maintain stable prices conducive to balanced and sustainable economic growth in the Philippines.

In the framework of comprehensive financial sector reform measures, BSP was restructured in 1993 attempting to meet the complex requirements of a modern banking system under the New Central Bank Act of 1993. The reform aimed at:

1. Giving BSP a greater autonomy vis-à-vis the government;
2. Increasing BSP's scope for an effective open market policy to control the money stock; and
3. Strengthening the Central Bank's capacity to exercise banking supervisory functions.

An interesting feature of the New Central Bank Act is that BSP is not permitted to engage in development banking or financing.

The Monetary Board, as the Bank's highest policymaking body, is composed of two representatives of the government sector and, to document the newly acquired greater autonomy, five full-time members from the private sector. Members of the Monetary Board are appointed by the President of the Republic to terms of six years.

1.2.2 Regulation and supervision

All regulatory issuances on the supervision of financial institutions are compounded in the "Manual of Regulations for Banks and Other Financial Intermediaries,"³ first published in 1982, with an updated version in 1991. Further amendatory and new regulations are incorporated in the Manual as semi-annual updates.

Since the mid-1980s, the regulatory framework for the financial sector has improved in terms of increasing the efficiency and stability of the banking system. A series of measures tightened the regulations related to minimum capitalization, the limitations and restrictions of loans to a single enterprise and the allocation of loans to management and shareholders. Complementary to these measures, financial reform aimed at improving financial intermediation through the listing of foreign banks, the permission of branching, especially for rural banks, and the loosening of regulations regarding equity participation among financial institutions themselves.

Regulatory requirements differ between commercial, thrift and rural and cooperative banks. Although all banks are regulated by BSP, they are licensed under different Acts of Parliament.⁴ The most significant difference among banks is with regard to minimum capital requirements. An expanded commercial bank is required to set up Ps4.5 billion (US\$118 million) and a regular commercial bank Ps2.0 billion (US\$53 million). For smaller banks such as rural banks, however, minimum requirements range between only Ps20 million (US\$526,000) in the Metro Manila area and Ps2 million (US\$52,000) for a bank in a 5th class municipality.

The capital adequacy ratio is uniform for all banks at 10% of risk-weighted assets. Also, reporting standards are generally similar and apply for all different types of banks.

³ The Manual is composed of four books: Book I - Commercial Banks; Book II - Thrift Banks; Book III - Rural Banks; and Book IV - Non-Bank Financial Intermediaries.

⁴ Among these Acts of Parliament are the Rural Bank Act for rural banks, the Cooperative Code for cooperative banks and the Thrift Bank Act for thrift banks.

1.2.3 General development and characteristics of the financial sector

The Filipino financial system is composed of formal, semi-formal and informal financial sectors. Formal financial sector institutions are regulated by the BSP and, in the case of insurance companies, by the Insurance Commission. This sector is presently composed of 53 commercial banks,⁵ 821 thrift banks,⁶ 810 rural banks, 39 cooperative rural banks⁷ and a number of specialized government banks. These financial institutions hold about 90% of total assets in the financial sector. Lending investors and pawnbrokers are the most dominant players among the non-banking institutions.

In the framework of financial liberalization, the universal banking system was introduced to the Philippines in the 1980s in the form of extended commercial banks. Limitations in banking operations related to certain types of financial institutions were considerably lowered. Differences between commercial banks, thrift banks, cooperative banks and rural banks remain in the areas of minimum capital and liquidity reserve requirements as well as in taxation.

Unlike in Thailand and Indonesia, the economic situation of Filipino commercial banks appears to be healthier. In terms of resource mobilization, profitability and capital adequacy, the commercial banks have performed better over the last years. The entry of ten foreign banks has increased competition and now causes banks to expand beyond main urban centers like Metro Manila, Davao and Cebu to start business in towns, cities and even first class municipalities.⁸

The semi-formal financial sector is composed of an estimated 10,000 multi-purpose and credit cooperatives, 500 NGOs and more than 50 donor and government target-group oriented credit programs. The Cooperative Development Authority (CDA) and the Securities and Exchange Commission (SEC) are the main regulating bodies of this sector. Finally, the informal financial sector is comprised of a variety of actors such as ROSCAs, self-help groups, friends and relatives, professional money lenders, trade creditors and farmer lenders.

Financial sector reform measures introduced since the mid-1980s have resulted in the strengthening of the formal financial market in the country. The measures include the creation of the new Central Bank, the relaxation of bank entry and branching, and interest rate deregulation. Financial reform, particularly the relaxation of bank entry and branching, has stimulated the increase in the number of banks, and thus has created a more competitive financial market. This competitive environment has also resulted in the introduction of a larger range of innovative financial products (financial broadening) and the outreach of financial institutions to new groups of customers (financial deepening). This

⁵ A full list of services provided by commercial banks includes deposits, loans, payment services, asset management and trust services, corporate finance and consultancy services, dealership and brokerage. Commercial banks are predominantly located in urban areas, including first class municipalities.

⁶ The group of thrift banks is composed of private development banks, savings and mortgage banks and stock savings and loan associations. Thrift banks predominantly serve small- and medium-scale enterprises outside the national capital region. Deposits mobilized by thrift banks account for 8% of the total deposits of the financial sector.

⁷ The first cooperative bank in the Philippines was founded in 1975 under the framework of the comprehensive land reform measures of 1972. Until the mid-1980s, cooperative banks were financed largely through subsidized credit programs. Today, the active mobilization of deposits to strengthen the banks' resources is gaining more and more importance.

⁸ See also GTZ, Country Study - The Financial Sector in the Philippines, Eschborn 1998.

effect is felt not only in the urban centers of the Philippines, but also in the fast-growing regional development centers in first and second class municipalities.

With the exception of the rural banks, the Filipino banking sector has traditionally been urban-based. The majority of rural people must rely on the services provided by semiformal and informal financial institutions. It is this sector that provides greater access to loan as well as deposit facilities for small, low-income households.

Due to the aforementioned urban bias of the banking system, competition among financial institutions in towns, cities and first and second class municipalities is high. However, rural areas in forth and fifth class municipalities are often characterized by the presence of only one financial institution, which is, in most cases, a rural bank. Thus, rural banks often behave like monopolists in rural areas when competition is low due to the absence of other financial institutions.

1.2.4 The impact of the Asian financial and economic crisis on the financial sector

The effects of the Asian financial and economic crisis are first and foremost reflected in rising levels of non-performing loans in the Filipino banking system. As of October 1998, commercial bank's non-performing loans ratio had deteriorated to 11.97%. The pressure on the banking system is also reflected in the increased volume of emergency loans of BSP extended to a few banks to help them overcoming temporary liquidity problems as a result of panic withdrawals. These emergency loans are equivalent to less than one percent of total deposits of the banking system and 0.6% of GDP.

It generally appears that the impact of the Asian crisis on the Filipino financial sector is considerably lower than in Thailand or Indonesia. In these countries, only massive liquidity assistance and bailouts could save the financial sector from collapsing.⁹ Formal banks in the Philippines are generally considered to be better capitalized with more adequate loan provisioning at par with those standards found in Singapore or Hong Kong. This, however, does not release the Government and Bangko Sentral from having to implement further necessary reform measures.

Another lesson from the financial crisis is that microfinance institutions appear to have performed quite well compared to commercial banks. Due to their non-involvement in higher risk activities such as foreign exchange operations and property finance microfinance institutions appear to have been less exposed. There is some evidence that well managed indigenous savings and credit organizations as well as cooperatives and rural banks experienced increasing inflows of deposits during the crisis. This phenomenon can be attributed to the close contacts of customers and members with the management of these institutions in smaller localities. Among the microfinance institutions in the Philippines it was reported that Grameen Bank replicators were able to cope better with the crisis than other MFIs. It was suggested that the poorest clients did manage to maintain their demand for credit while other less-poor clients had to reduce it.¹⁰

1.2.5 Outreach and characteristics of state interventions

Hand in hand with ongoing financial reform measures such as liberalizing interest and foreign exchange rates and privatization of government-owned banks (Philippine National Bank),

⁹ Liquidity assistance to Banks in Thailand and Indonesia are equivalent to 15% of GDP.

¹⁰ For more information see *Banking with the Poor (BWTP)*, The Asian Financial Crisis - Implications for Microfinance, Newsletter, No. 11, June 1998.

state interventions in the market have been decreasing over the last years. Despite the progress made, state interventions are still dominant to promote the development of the countryside in general and certain target groups in particular. As a measure to ensure recovery from the economic slow down during 1998, the "easing up of credit to farmers" is once again considered key to smoothen investment and consumption.¹¹

A regulation concerning thrift and rural banks on required credit allocations of 5% of total loan portfolio to small enterprises was phased out by December 1997. Nevertheless, these financial institutions are still obligated to allocate 25% of their loanable funds to the agricultural sector. The Deposit Retention Scheme aims to ensure that financial institutions reinvest at least 75% of the deposits mobilized outside of the National Capital Region in the countryside. However, most of these regulations can be circumvented legally through the application of substitution clauses.

Government-run credit programs aiming at providing small farmers, fishermen, micro-entrepreneurs and rural women with credit facilities are often not sustainable due to below-market interest rates. The Landbank of the Philippines (LBP), as the government bank to serve the countryside, is extending agricultural loans to cooperatives at a subsidized rate of interest, which tends to lead to market distortions by prejudicing private financial institutions that cannot compete at these rates. However, with further decreasing interest rates in the financial system, the gap between LBP subsidized interest rates for agricultural production loans and market rates will become more and more negligible over time.

1.2.6 Social security system

The social security system in the Philippines covers both government and private employees. Government employees are under the "Government Service Insurance System" (GSIS). The "Social Security System" (SSS) for private employees applies to all employer-employee relations. However, enterprises below ten employees and below total assets of US\$78,000 are exempted from social security regulations. Taking into account that cottage industries and microenterprises are below this level, a large portion of the private sector, both in urban and rural areas, is without social coverage.

1.3 Social and socio-cultural context

Panabo is a first class municipality of the Davao Province situated in Southern Mindanao. It is approximately 30 kilometers from Davao City¹² and 28 kilometers from Tagum, the capital town of Davao Province. The population of Panabo is estimated at 100,000, with an average density of 300 persons per square kilometer.¹³ Data as of 1988 indicate that roughly 85% of the total labor force of the municipality is employed in the agricultural sector. This figure has certainly changed within the last ten years. The commercial, industrial and service sectors have gained importance without, however, questioning the dominance and importance of the agricultural sector for Panabo.

Although savings in the Philippines in rural areas (fourth and fifth class municipalities) are generally rather in physical assets and in livestock, it is believed that financial assets in the

¹¹ See NEDA, 1998 Economic Performance, <http://www.neda.gov.ph>.

¹² Davao City is the third largest city in the Philippines, with an estimated total population of 1.5 million.

¹³ For comparisons: Bangladesh 820 persons per square kilometer, Thailand 113 persons per square kilometer, Bolivia 6.5 persons per square kilometer, Colombia 31.6 persons per square kilometer and Mali 7.6 persons per square kilometer.

Panabo region account for the largest portion of the average household's assets. Thus, the exchange of goods and services is predominantly settled by monetary transactions.

1.4 Classification of the macroeconomic, financial and socio-cultural context

Between 1994 and 1997, the Philippines have witnessed a turn-around in the economic performance of the country, after decades of stagnation. Growth of the economy steadily increased from 1991 to 1997, while inflation rates continuously decreased. In 1998, however, the Philippines were fully hit by the Asian financial crisis with currency devaluation, higher interest rates and decreasing output. In addition, the El Niño phenomenon further worsened the macroeconomic picture in 1998 with shrinking agricultural production.

Although the severity of the crisis appears to be less than e.g. in Thailand or Indonesia, the country will need some years to reach those levels achieved in the mid-1990s. There are some encouraging signs that the country will come back on a slow but steady growth path: the exchange rate remained stable over the past 12 months, interest rates are decreasing and a moderate positive growth rate is predicted for 1999. Yet, it will take enormous efforts to smoothen the economic and social disparities between the urban and rural areas in the Philippines.

With regard to the financial sector, comprehensive reform measures have contributed to the good economic performance of the Philippines until the onset of the crisis. The financial system has been expanding through both financial broadening and deepening. The banking institutions appear to be financially more healthy than elsewhere in Southeast Asia. No regulated financial institution has failed yet. The countryside is, however, still underserved by rural financial institutions, which tend to focus on urban areas due to presumed higher rates of return in new dynamic sectors. Government interference in rural finance is still widespread, particularly through numerous subsidized credit programs.

Although the socio-economic importance of the agrarian sector for the first class municipality of Panabo is decreasing, agriculture is still the dominant sector in Panabo in terms of employment and value added. The region is not excessively exposed to natural calamities. The economy is highly monetarized.

2 INSTITUTIONAL ANALYSIS

2.1 General characteristics of the Rural Bank of Panabo

Brief historical background: Rural Bank of Panabo (RBP) started operations in 1967. The founders of the bank were prominent doctors, businessmen and farmers from Panabo and Davao. The majority of the shares was primarily held by the members of three families. In the early stages the bank's policies were reported to be very conservative and risk-averse. One of the most critical situations the bank ever had to face was in 1987 when President Aquino was assassinated and clients started massive withdrawing of deposits. While two commercial banks in Panabo closed during these critical days, Rural Bank of Panabo continued to serve its depositors due to prudent liquidity management.

Like every other rural bank in the Philippines, RBP participated in the so-called "Masagana 99" supervised credit program of the Filipino Government in the 1970s. The supervised credits primarily served to finance agricultural production inputs for groups of farmers and cooperatives with subsidized interest rates. The loans were provided without collateral. Repayment was very low, resulting in a 12% default rate in 1979, which was, however, still above the industry's average concerning the collection of "Masagana 99" loans.

With financial liberalization in the 1990s, which allowed the rural banking industry to branch out, RBP began expanding its operations. In September 1996, a branch was opened in Panabo, to be followed in March 1997 by a second branch office in Carmen, a third class municipality. Through the years, the bank has received numerous awards from the Central Bank for its successful management and its strong commitment to countryside development.

A rural bank has a number of characteristics that differentiate it from commercial, thrift or cooperative banks. Rural banks are:

- Locally based, because they were originally conceived of as unit banks;
- Basically limited to loan and deposit operations (no securities business);
- Private-run enterprises with shareholders and management originating from the region;
- Small financial institutions in terms of equity capital (up to US\$2 million), deposit liabilities (up to US\$11.5 million) and total resources (up to US\$15.5 million); and,
- Servicing the countryside (fourth and fifth class municipalities), especially farmers, fishermen and small agro-based businesses.

RBP faces competition from a number of different banks such as Security Bank, Bank of the Philippines - Family Savings Bank, Landbank of the Philippines and two rural banks. In terms of number of clients, RBP is probably the number one bank in the municipality.

RBP does not specifically target certain sectors. Its main customer base is composed of small depositors and borrowers across all sectors such as farmers, fishermen, market vendors, small entrepreneur and microentrepreneurs, government and private sector employees. Although women account for more than 50% of the bank's clients, there is no specific gender-related bank policy towards that target group.

As far as savings products are concerned, RBP offers its clients three basic deposit services: demand deposits or current accounts, regular savings deposits and time deposits. The average regular savings deposit is approximately US\$220. The bulk (62%) of the total 11,386 savings accounts shows a balance below US\$50. Including all accounts up to US\$100, the share of small deposit accounts to total accounts increases to almost 80%. This appears to

be a clear sign that RBP is, in fact, reaching small depositor clients. In addition, the bank is increasing its deposit base through a linkage with self-help groups composed largely of farmers and women who meet regularly to save small amounts. The bank offers withdrawable and non-withdrawable accounts.

On the credit-side, RBP offers various products addressing certain target groups like cooperatives, solidarity groups, market vendors and salaried employees. The bread and butter product for RBP is the salary loan, which is directly deducted from the payroll of the borrower. The average salary loan is US\$617 and accounts for 85% of total loans allocated. Roughly 11% of total loans allocated are below US\$100. Almost 15% of the loans range US\$1,001-US\$5,000. Only 1% of total loans are above US\$10,000. The overall average loan size is US\$880, which demonstrates that the bank, as with deposits, is in a position to serve small enterprises.

Over the last three decades, RBP has continuously augmented its total resources, both assets, in particular the loan portfolio, and deposits. Starting credit business in 1967, the bank's loan portfolio reached US\$8.6 million by the end of 1996. The quality of the loan portfolio did not suffer from the expansion. The average annual arrears in 1996 to average annual outstanding loans were clearly below 10%. The risk asset ratio was nearly 22%, above the required 10% Central Bank regulation. Deposits grew steadily over the years and total savings today amount to US\$5 million. The share of total deposits to total liabilities of 72% indicates the bank's strong performance in deposit mobilization.

With a return on equity (ROE) continuously above 30% over the last years, RBP is probably one of the most profitable banks of its kind in the Philippines. This is due to a comfortable interest rate spread of 15.4%, low loan loss provisions and reasonable administrative costs. However, some ratios, such as average annual value of savings per staff, show a decline in operational efficiency. This is related to the high investments in human resources due to RBP's expansion policy. In time, business volume will pick up to compensate for the expenses related to staff recruitment.

2.2 Institutional type, governance and organizational structure

2.2.1 Institutional type and governance

Rural Bank of Panabo was founded under the Rural Banks Act, Republic Act No. 720 of 1952 in the form of a stock corporation.¹⁴ It was registered with the Securities and Exchange Commission (SEC) as Rural Bank of Panabo (Davao), Inc., in October 1966. Rural banks in the Philippines were designed "to make needed credit available and readily accessible in the rural areas on reasonable terms."¹⁵ They were initially conceived as unit banks and were only recently allowed to branch and merge. The Banking Act emphasizes that the purpose of rural banks is to serve rural communities with adequate credit facilities. The deposit-mobilizing function has thus been neglected in the Act, except that a rural bank may administer savings and time deposits as well as checking accounts.

¹⁴ The original Rural Banks Act was amended in 1992 by Republic Act No. 7353 (known as the Rural Banks Act of 1992).

¹⁵ Quoted from the Republic Act No. 7353, Section 2. Since its start in the 1950s, the rural banking system grew steadily. However, rural banks' operations were greatly affected by government policies and programs from the mid-1960s to the early 1980s, when rural banks were used as conduits for targeted and subsidized credit programs. As a result, only 800 of the 1,200 rural banks survived and continued to operate after the crisis.

Apart from the above-mentioned Banking Act and the Central Bank Manual of Regulations, which applies to the operations of all rural banks, RBP's by-laws constitute the bank's own set of regulations. The by-laws are composed of the following seven subsections:

- Office;
- Capital stock;
- Meetings of stockholders;
- Directors;
- Committees of Directors;
- Officers;
- Miscellaneous provisions.

The Board of Directors (BOD) is the decision making body and approves the general policies, rules and regulations of the bank. The Board is presently composed of five members: the chair, the president, the general manager and two ordinary members. With the exception of the general manager, the board members are not professional bankers. All Board members are long-time residents of Panabo who know the clients and the environment in which they operate very well. Board meetings take place regularly on Friday, at least three times a month.

The authorized share capital of RBP is US\$880,000, divided into 200,000 shares of common stock and 5,000 shares of preferred stock, both at the par value of US\$3.8. The present paid-in capital is US\$0.8 million. Originally, RBP was owned by the seven founders, but within the course of time, shares have been transferred to children and life partners. In addition, bank staff and some new investors acquired shares, thus increasing the present number of stockholders to 80. Despite the transfer of shares over the past years, the majority of shares, an estimated 80%, is still held by the families of the original founders. Beyond these, the new shareholders, e.g. bank staff, are also for the largest part from the community. Thus, the shareholders and owners of RBP still originate from the Panabo region and are well known among residents and clients.¹⁶

The shareholders of RBP gather at least once a year at an annual meeting. According to the by-laws, special meetings can also be called by the President, the BOD or the stockholders representing a majority of the shares. The order of business at the annual meeting includes the election of the Board of Directors, which is, however, subject to approval by the Monetary Board of the Central Bank.

As a stock corporation, RBP is liable for its obligations with its risk capital. The liability of shareholders is limited to their share in total risk capital. Deposits from the public are insured against bank insolvency through membership in the Philippine's Deposit Insurance Corporation (PDIC). Membership is compulsory and covers losses on individual accounts up to deposits of US\$3,850. This appears to be sufficient to protect small depositor savings.

2.2.2 Organizational structure

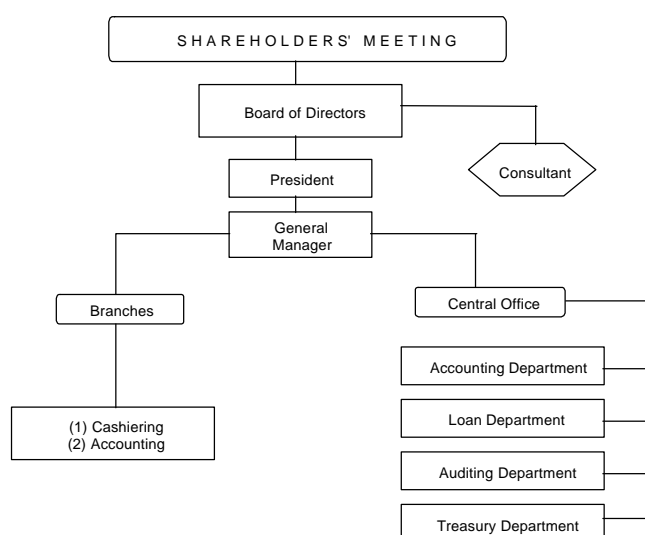
Rural Bank of Panabo operates one central office and two branches. The branches were opened in September 1996 and March 1997. The Maharlika Branch is located very near (400

¹⁶ RBP plans to increase paid-in capital to US\$960,000 through the declaration of a cash dividend. Following bank regulations, subscribed and authorized capital will thus be raised to US\$1.5 million and US\$3.8 million respectively.

meters) to the bank's head office. Operations are limited to cashiering and screening of clients for loan applications. The second branch is situated on a main road seven kilometers from the head office, in the municipality of Carmen. The branch is located opposite a public market. Like Maharlika, the Carmen branch serves primarily to raise local deposits, although some loan products will soon be introduced.¹⁷

With the expansion into branches, RBP has increased its staff to 39 members, divided into the following categories: three top-management staff, eight middle-management staff, 22 ordinary and six auxiliary staff. Six persons are presently trained to be employed in one of the branches. There are no special savings officers. However, RBP employs five tellers in its head office to rapidly serve the clients. This is above the average of the banking industry. The operational structure is characterized by the branch operations on the one hand, and the four main departments, accounting, loan operations, auditing and treasury of the central office on the other hand. The organigram below describes the organizational set-up of RBP.

Graph 1: Organigram of Rural Bank of Panabo



The Board of Directors (BOD) generally decides on the policies of the bank. This includes the loan approval for first time applicants as well as the loan approval of old clients when they request increased loan amounts. The General Manager (GM) manages the daily bank load by liaising closely with the President. With respect to savings aspects, the GM decides on the bank's deposit interest rate policy. RBP generally applies an above-market deposit rate, i.e., Treasury Bill Notes plus a mark-up of 3% for time deposits. The bank aims at always being at least 1% above the competitors in town. The former President of the bank is now assisting RBP as a consultant. His competence and vision in rural banking matters have contributed to the bank's good performance in the past. His distinct influence in Board meetings is very obvious.

Rural Bank of Panabo is a member of the Rural Bankers Association of the Philippines (RBAP), which is the national body of 810 rural banks nationwide. Through its technical arm,

¹⁷ The bank plans to further expand and to set up more branches. The next three branches are planned in Sto. Tomás (third class municipality), Tagum (first class municipality) and Kapalong (third class municipality).

the Rural Bankers Research and Development Foundation (RBRDF), the association provides technical services to the banking system. For various reasons, the scope and quality of the services provided are not yet sufficient. RBP is therefore planning to enter into a strategic alliance with Network Bank, the largest regional rural bank in Mindanao.¹⁸ Network Bank will act as a technical support institution for auditing, product development and human resource development.

The establishment of two branches was part of the bank's strategy to get closer to the clients and especially to service small depositors. The outlets are limited to cashiering functions only and are located in economically busy areas. While the Carmen Branch closes on Sunday, Maharlika Branch is open seven days a week. The two banks are designed as "drive-through banks" which appears to be a very progressive concept given the rural character of the area. While the clients rarely use the drive-through, the concept helps shaping the image of a modern, progressive bank, which does not conflict with servicing rural clients.

2.2.3 Lessons learned in institutional type, governance and organizational structure

2.2.3.1 Success factors

Community orientation. For more than 30 years, the shareholders and the management of Rural Bank of Panabo have been well known in the community. Unlike commercial banks where management rotates every two to three years, rural banks are managed on a continuing basis with the same staff, except for normal fluctuations. This helps to build up trust and confidence among clients who want to deposit their small savings. These relations between customers and the bank, characterized by mutual trust, even attract some clients who could deposit with commercial banks.¹⁹

Setting up of branches. The concept of setting up small branches in well-selected locations with operations limited to cashiering contributes to the bank's rising deposits. The branches, as well as the central office, are very spacious, clear and fully computerized. Customers depositing or withdrawing are served within minutes.

2.2.3.2 Limitations and risks

Lack of network. Generally, a Rural Bank does not dispose of a region-wide or nationwide network of branches to provide customers with possibilities to withdraw savings from their accounts in other municipalities. In an increasingly competitive environment, the absence of a network constitutes a disadvantage linked to the institutional structure of a rural bank. The only solution to get access to regional markets is to build up alliances with other financial institutions or to aggressively branch out.

Access to support services. The development of new savings and loan products, the training of staff and the enforcement of effective auditing and control mechanisms are expensive. The costs involved can hardly be borne by a single rural bank. To compete in the long term, financial institutions like rural banks need effective support services that could be provided by a national apex organization, regional federations or, again, by alliances with other financial institutions.

¹⁸ Network Bank and RBP are considering a stock swap (Network Bank will hold 35% of RBP, whereas RBP will hold 18-20% of Network Bank).

¹⁹ A customer survey conducted by the researcher showed that customers deposit with the bank because they know the family that holds the majority shares of the bank very well.

2.2.3.3 Possibilities of replication

Replication in a relatively non-competitive environment: The institutional type, governance and organizational structure of Rural Bank of Panabo appear to be rather traditional and in line with general banking approaches. The observed ties between the shareholders, the management and the customers favor the mobilization of local savings from the community. In an environment without much competition, the institutional type "rural bank" is therefore an ideal instrument for deposit mobilization.

Replication in a relatively competitive environment: In an increasingly competitive environment, a "rural bank" needs partners to share in the investments for human resource development, product development, auditing, etc. A replication of the rural bank model in a more competitive situation would, thus, only make sense if possibilities to get access to support services had been identified a priori.

2.3 Demand-oriented savings products and technologies

2.3.1 Characteristics of demand-oriented savings products and savings technologies

Rural Bank of Panabo offers its customers two classic savings products, regular savings and time deposit, plus an interest-earning demand deposit. These products only differ from the commercial banks' savings products only insofar as they are adapted to the needs of small depositors. A more innovative product is the one for so called self-help groups (SHGs) composed of mostly farmers banded together to pool their savings and to eventually get a loan from RBP. The savings products of RBP have the following characteristics, special features and target clientele:

- Demand deposit account: Due to competition with commercial banks in the Panabo region, RBP pays an interest rate of 3% p.a. to its customers if the Average Daily Balance (ADB) of the current account is above US\$75. A drop of the balance below that level will lead to a penalty of US\$2 a month. The initial deposit required is US\$115. Demand deposits are targeted at better-off clients such as businessmen and salaried employees. Total demand deposits account for roughly 3.5% of the total number of savings accounts and for 6.6% of RBP's total deposit liabilities.
- Regular savings account: To open up a regular savings account, only US\$3.8 are needed. However, only accounts above US\$19 earn interest. The minimum to maintain the savings account is also US\$3.8. Interest rates for amounts up to US\$11,500 are 3% p.a. 1% more is paid for amounts up to US\$19,200. Finally, customers receive the premium rate of 6% p.a. for deposits above US\$19,200. As of December 1996, RBP had a total of 10,460 regular savings accounts with deposits equal to US\$2.3 million, which accounts for 46% of their total deposit liabilities.
- Time deposit account: Interest rates on time deposit accounts vary considerably between 6.5% p.a. for savings up to US\$752 and 16% p.a. for deposits above US\$19,200. The interest rates for time deposit accounts are based on the treasury bill rates, plus 3% p.a. Requirements for the minimum initial deposit amount and the minimum interest-earning average daily balance are the same as for the regular savings accounts. Time deposits also account for roughly 46% of total deposit liabilities, yet the number of accounts only amounts to 4.6% of the total.

- Self-help group savings account type I - non-withdrawable:²⁰ Each member of a SHG is required to pledge an amount they are willing to save regularly on a weekly or monthly basis. Savings must be regular for at least six months. Members who fail to meet with this commitment are automatically dropped from the SHG's list of members. The withdrawal of deposits is only allowed under special circumstances.²¹ The savings methodology resembles a life insurance policy or a retirement plan. Interest is up to 6% p.a. The deposited amount can also serve to receive a loan on a 1:2 basis from the rural bank.
- Self-help group savings account type II – withdrawable: In order to offer SHGs a savings product that also meets emergencies or providential needs, RBP introduced a withdrawable savings scheme. The withdrawable savings account earns an interest rate of 3% p.a. compared to 6% p.a. for the non-withdrawable type. The number and amounts of withdrawals are not subject to restrictions.

2.3.2 Design of demand-oriented savings products

Due to the classical type of the savings products and the obvious need among the rural low-income people for savings services, no in-depth marketing studies were conducted prior to the introduction of these products. However, for loan products such as the market vendor product, marketing studies were executed by RBP prior to the implementation of the products.

2.3.3 Procedures to introduce demand-oriented savings products

In the past, Rural Bank of Panabo has participated in national as well as regional savings campaigns as part of the bank's general objective to raise its resources. A very specific and successful instrument for the bank to promote deposits is the raffle contest. It is an incentive for the customers to increase their deposits. For every US\$38 in his/her time deposit account, a depositor is given one raffle ticket. A raffle ticket gives the depositor the possibility to win substantial cash and non-cash prizes such as motorbikes. A raffle contest is normally run over six months. The additional amounts of savings mobilized with Rural Bank of Panabo have been reported to be considerable with the additional effect of improving the image of the bank.²²

Before a self-help group savings²³ program can start, the potential members must form a group. There are basically four major steps that must be taken into account in the organization of a self-help group (SHG):

- Identifying the group: the bank generally prefers to deal with already-organized groups such as associations of farmers, tricycle drivers, teachers or market vendors.

²⁰ At present, RBP is lending to 17 SHGs with an average membership of 45 persons. Roughly 70% of the group members are female. The amount of savings mobilized by SHG vary considerably between US\$380 and US\$4,620. Due to the relatively low number of groups, the share of savings mobilized by SHGs compared to total bank savings is rather low. Likewise, the share of SHG loans to total outstanding loans is low with approximately 0.5%.

²¹ 1. Upon the death of a member. 2. Permanent transfer to a place where continued membership is not possible. 3. Upon reaching the age of 60 if the member decides to retire from the association. 4. Inability to engage in productive undertakings due to physical or mental incapacity.

²² For more information on the concept and experience of raffle contests see Rural Bankers' Research and Development Foundation, Deposit Generation through the Regional Raffle Contest: The Davao Federation of Rural Bankers Experience, March 1991.

²³ The concept of mobilizing savings through SHGs has been jointly promoted by the Rural Bankers Association of the Philippines (RBAP) and GTZ since 1990 through the Project "Linking Banks and SHGs."

- Motivating the SHG members to save: in an informal meeting with the potential group members, the rural bank informs them about the purpose and procedures of the savings plans.
- Preparation of documents: after an agreement between the bank and the SHG to save regularly has been reached, the members prepare and fill out their constitution and by-laws, membership application forms and the savings pledge forms.
- Upon the initial deposit of the SHG's pledged savings, the passbooks for each member of the SHG are handed out by the rural bank.

A general policy of Rural Bank of Panabo to increase its deposit base is to always offer customers a savings interest rate that is 1% above the rates of the competitors. Thus, the posting of interest rates within the municipality is monitored regularly by the bank.

2.3.4 Lessons learned in the design and handling of demand-oriented savings products and technologies

2.3.4.1 Success factors

Adaptation of traditional savings products to the needs of small depositors. Around 82% of total deposits are made in regular savings account and time deposit accounts. Both types are offered by every commercial bank. However, RBP adjusted the features of the accounts to the needs of small depositors by lowering the minimum initial capital amount to US\$3.8. The bank offers higher deposit interest rates than its competitors in the financial market. Even for a demand deposit account, RBP offers 3% to attract new customers.

Innovative measures to promote savings. Rural Bank of Panabo regularly holds campaigns for savings mobilization. Raffle contests are popular among customers and increase the bank's resources de facto.

2.3.4.2 Limitations and risks

Limitations of compulsory SHG savings. The analysis of RBP's experience with withdrawable deposit accounts versus non-withdrawable accounts for SHGs provides some interesting insights: Regular and continuous pledged savings over years with the aim to get access to providential loans is dangerous for members because their repayment capacity does not increase proportionally to their savings. Further, from the bank's point of view, a non-withdrawable savings product will hardly mobilize savings to a greater extent because the money is not available for SHG members in case of emergencies.

2.3.4.3 Possibilities of replication

Replication of other success factors in a competitive environment. A financial institution that is competing with other banks for customers' deposits can replicate promotional measures such as the execution of raffle contests or the payment of a higher savings interest rate. A financial institution acting like a monopolist probably will not see the need to introduce more incentives for deposit mobilization.

2.4 Management capabilities

2.4.1 General management capabilities

Newly recruited personnel are under 25 years of age. Candidates are expected to have at least a college degree and preferably to be a resident of the Panabo community, which is of

particular importance for tellers. In line with CB regulations, at least 50% of the total staff must be from the municipality. A specific economic or banking background is not necessarily required - RBP relies on internal and external training measures to train new staff members. An independent agency screens and tests possible candidates. The final selection, however, is the responsibility of the bank.

The bank has introduced a number of incentives to raise the productivity of its staff members:

- Tellers receive a monthly "shortage allowance" of US\$23 in addition to their base salary. The allowance serves as a personal fund from which eventual cash deficits must be paid back to the bank.
- A quarterly performance bonus of 10% out of the net income after taxes is paid to all staff members if the set economic and financial targets of the bank have been achieved in that period.
- The bank regularly selects the employee of the year and the most productive employee of the year. The winners are given awards and are sent on a one-week trip to attend the national rural banks convention.
- Apart from giving cash bonuses or incentives that affect the salary of the staff, the bank rewards performance by distributing a minimal amount of shares to the bank employees.

The management acknowledges the importance of human resource development for the bank. Each staff member is eligible to participate at least once a year in a training course or seminar on bank-related affairs. The bank either conducts training on its own or relies on external organizations, such as the Rural Bankers Association, the regional rural banker federation, or consultants and donor programs to conduct the training.²⁴

The management information system (MIS) of the bank provides the management basis with information on the bank's operations on a daily, weekly, monthly, quarterly, semi-annual and annual. One of the main pillars of the MIS is the daily fund monitoring. This determines the excess or deficit in liquidity after deducting the required liquidity from total cash funds. The (risk) asset structure compared to the net worth is also calculated daily. The Microbanker²⁵ consolidates all accounts at the end of the day and provides the management with financial statements on a quarterly basis. The performance of the bank is analyzed comprehensively at the end of the year, based on the data received through the MIS; depending on the outcome of the evaluation and taking into account future prospects, new targets are set for the next year in deposit mobilization, loans outstanding and net income.

2.4.2 Special management capabilities: Risk management

Total assets of RBP have considerably increased over the past years from US\$5.3 million in 1994 to US\$8.6 million in 1996. As of December 1996, the assets were composed of the following main positions: cash (5%), financial assets (15%), outstanding loans (73%), equity investments (0.2%), fixed assets (4.8%) and other assets (2%). The rise in total assets can largely be attributed to the continuous expansion of the bank's loan portfolio.

²⁴ In 1996, RBP organized and conducted seven seminars/trainings on the following topics: (a) Team building; (b) Quality services and customer relations; (c) How to supervise people; (d) Effective and efficient property valuation; (e) Performance appraisal system; (f) Financial analysis and reporting; (g) Entrepreneurship development program.

²⁵ The Microbanker (registered trademark) is a microbanking software developed by FAO.

The Central Bank has issued a comprehensive definition of risk assets. According to that definition, risk assets are total assets minus non-risk assets such as cash on hand, amount due from the Central Bank, investment in government bonds, bank premises depreciated, and furniture, fixtures and equipment depreciated. Applying that definition, total risk assets account for roughly 88% of the bank's total assets. The risk assets are mainly composed of outstanding loans (82%) and deposits due from other banks (13.5%). The Central Bank has determined the risk asset ratio (net worth to risk assets) for rural banks at a minimum of 10%. RBP's risk asset ratio is continuously 21% or above.

The bank's loan portfolio measured against volume consists of agricultural (11.4%), commercial (9.2%) and industrial loans (27.2%). Loans to SHGs are negligible. However, the bulk of credit is directed towards salaried employees, with a share of 52% of the total loan portfolio. The special feature of salary loans is the direct deduction of the loan payments from the borrower's payroll, which needs, a priori, a special agreement between the bank, the employer and the borrower. For RBP, a salary loan constitutes a very good risk because regular payment by the borrower is almost guaranteed. The majority of these loans, however, are taken for consumption purposes.

The bank monitors the composition and performance of its risk assets regularly, often on a daily basis due to specific Central Bank requirements on the determination of the risk-asset ratio. The bank also monitors the limitations of investment in allied undertakings (not more than 15% of net worth) and restrictions of investment in fixed assets (not more than 50%). Lending to stockholders is also limited. Loan arrears are monitored closely and transferred to a special past-due account one day after the due date. The present past due rate is roughly 9%.

2.4.3 Special management capabilities: Liquidity management

The bank's total liabilities as of December 1996 amounted to US\$7.0 million. Deposit liabilities accounted for roughly 72% of total liabilities followed by deposits due to banks (15.4%) and rediscounting with Land Bank (7%). Within the last two years, total liabilities rose by 64% from US\$4.2 million in December 1994 to US\$7.0 million in December 1996.

In terms of volume, both time deposit accounts and regular savings accounts mobilized roughly US\$2.3 million as of December 1996, each representing roughly 46% of total deposits. The remaining share of 7.5% consists of demand deposit accounts. Looking at the number of accounts, the regular savings accounts take the lead with a total of 10,460 accounts, which amounts to a share of almost 92% of all accounts. Time deposit accounts hold a share of 4.6% and demand deposit accounts, a share of 3.4%.

The statistics indicate a dominance of female clients as holders of savings accounts in numbers as well as in volume for each category of accounts. In terms of total number of accounts, female clients outperform male clients by 43% and by 50% regarding volume. These figures demonstrate, once again, the importance of female depositors and borrowers for financial institutions. Yet, without further research, these figures have to be interpreted cautiously because many female clients, according to bank staff, may open accounts for their household on behalf of their husbands.

The number of opened and closed accounts throughout the year appears to be relatively high measured against the number of total accounts. In 1996, roughly 2,500 regular savings and 2,750 time deposit accounts were opened. The combined figures account for approximately 46% of total accounts as of December 31, 1996. In the same period, however, roughly 3,900 accounts were closed. While the time deposit accounts are not conceived as continuous savings instruments, the high number of opened and in particular closed regular

savings accounts is difficult to explain. The number of transactions on the regular savings accounts to make deposits (90,052) and withdrawals (117,316) in 1996 is also quite high. The total volume of deposit transactions amounts to US\$60 million, and for withdrawal transactions to US\$52 million. A high volume of savings transactions, as shown above, supports the need for effective liquidity management.

The basic instrument for RBP's liquidity reserve management is, as mentioned before, the fund monitoring system of the MIS. The fund-monitoring sheet presents the deposit liabilities of the bank and the required liquidity.²⁶ Cash funds and required liquidity are compared to calculate the excess or deficit of funds. The monitoring sheet is prepared each morning by the chief accountant and submitted to the general manager. Depending on the balance, either investments or disinvestments respectively will be made to lower or to raise liquidity.

In case of urgent liquidity needs, RBP will first withdraw its funds from various commercial and government banks in the region.²⁷ In addition, the bank has access to credit lines with various banks and financing agencies.²⁸ Total available credit lines amount to US\$4 million, of which RBP used US\$1.5 million in 1996. Despite these credit lines, the bank has not yet immediate access to any liquidity pools where funds would be available on very short notice for overnight purposes.

2.4.4 Lessons learned in management capabilities, especially risk and liquidity management

2.4.4.1 Success factors

Human resource development and incentive systems. RBP's success is built upon its workforce and the commitment to continuously upgrade the banking skills of the staff. Recruitment procedures emphasize the selection of officers from the municipality to ensure social ties with the community. Incentive systems, such the shortage allowance and performance bonus, increase the efficiency of the staff.

A management information system provides the management with the most important data on the bank's operations.

Active asset management: The bank is not overexposed to risks. A well-balanced composition of assets, especially related to the diversification of the loan portfolio through salary loans, puts the bank on solid financial grounds. This is achieved through an active management of the assets by constantly monitoring and controlling key ratios.

High liquidity preference: Throughout its history, the bank has always emphasized the importance of liquidity because savings are subject to strong fluctuations. This is reflected in the RBP's liquidity preference of 20%, which is above the Central Bank's regulation. The fund monitoring system applied by the bank allows an active management of the liquidity.

²⁶ Rural Bank of Panabo's liquidity preference is at present 20% for both time and regular savings deposits. This exceeds Central Bank regulations.

²⁷ Rural Bank Books, BPI Family Panabo, Far East Bank and Trust Company Tagum/Maharlika/Quirino, LBP Panabo/Maharlika/Quirino, Solidbank, Prudential Bank, Security Bank.

²⁸ LBP, Solidbank, Far East Bank and Trust Company, UCPB, SMEC, SBGFC, CLF.

2.4.4.2 Limitations and risks

MIS is not yet an integrated system: Although the bank is computerized, the MIS is not really a system, but rather a collection of different subsystems without any links. Most of the data from the accounting unit used for fund monitoring or the determination of the risk assets cannot immediately be derived from the different subsystems.

No quick access to liquidity pool: The bank has access to some forms of liquidity facilities. However, a rapid and efficient access to a liquidity pool is lacking. This is one of the main issues individual rural banks in the Philippines are facing.

2.4.4.3 Possibilities of replication

General assessment. Today, the importance of human resource development is generally acknowledged and thus should be part of the in-house strategy of any financial institution. RBP shows that innovative incentive systems can improve staff efficiency. Active asset and liquidity management are equally important to limit the banks' exposure to risks. The replication of these management capabilities would require considerable effort in training of bank staff and capital to build up a supporting management information system.

2.5 Regulatory and supervisory framework

2.5.1 External regulation and supervision mechanisms

The Central Bank Manual of Regulations encompasses all regulatory issuances of the supervision of rural banks. Together with the Rural Banking Act, the manual constitutes the basic reference with which the operations and by-laws of rural banks must comply. The manual is divided into three main chapters: Part I - Organization, Management and Administration, Part II - Deposit and Borrowing Operations, and Part III - Loans, Investments and Special Financing Programs. Some of the pertinent regulations follow:

- **Qualifications of directors and officers:** A director of a rural bank must be a Filipino citizen holding at least one voting stock in the rural bank. He/she has to be at least 25 years of age and be a college graduate or have at least five years experience in business or have undergone training in banking provided by the Central Bank. The requirements for officers are similar, except that the minimum age for officers is 21 years and the majority of the key executive officers of the rural bank must be residents of the locality where the rural bank is operating.
- **Net worth to risk asset ratio:** The total capital of a rural bank must be above 10% of its risk-weighted assets.
- **Internal control:** Rural banks accounting and reporting must comply with the uniform accounting system prescribed by the Central Bank for rural banks. The manual clearly spells out regulations on joint custody, signing authorities, dual control mechanisms, bank protection and security devices.
- **Limitations of investments in fixed assets:** The maximum amount that a rural bank may invest in bank buildings and property may not exceed 35% of the bank's paid in capital plus surplus. Furniture, fixtures and equipment including motor vehicles may not exceed 15% of the bank's paid-in capital and surplus.
- **Reserves against deposits:** Historically, the required reserves against deposits for rural banks have always been 2-3% below the required levels for commercial banks and thrift banks. This privilege was granted to rural banks in order to release more credit to the poor farming and agricultural sectors in the countryside. At present, required reserves for

deposits at rural banks are as follows: 11% against demand deposits, 8% against savings and time deposits of less than 730 days, and 10% against time deposits over 730 days.

- Capitalization requirements: The required paid-in capital for rural banks depends on the location where the bank operates. There are three categories: In fifth and sixth class municipalities and towns, a paid-in capital of US\$77,000 is required. In second, third and fourth-class municipalities and towns, and fourth class cities, a paid-in capital of US\$115,000 is required. In first class municipalities and towns, and second and third class cities, US\$192,000 must be paid in. The latter case applies to Rural Bank of Panabo.
- Investments in and loans to enterprises: The total equity investment of a bank (a) in any single enterprise is not to exceed 15%, and (b) in all enterprises is not to exceed 25% of the net worth of the investing bank.
- Writing off of loans as bad debts: Loans are considered past due when they are not paid at maturity. Only loans that have been past due for six months or more and that have been declared uncollectable may be written off. The Monetary Board of the Central Bank must approve the writing-off of loans to directors, officers, and stockholders.

The enforcement and supervision of the Central Bank regulations for rural banks is exercised by the Central Bank itself. Weekly, monthly, quarterly, semi-annual and annual reports prepared by RBP serve the Central Bank to assess the performance of the rural bank. A comprehensive audit is conducted once a year at an unannounced time. A private auditing company contracted by Rural Bank of Panabo verifies the accounts and financial statements on a quarterly basis.

Regulations on the rural banks operations are certainly comprehensive and directed to implement sound banking practices. Restrictions and limitations on banks' investments in risk assets and the formulation of liquidity ratios contribute to lowering the risks that a financial institution is naturally exposed to, and to protecting the deposits of small customers. However, the capacity of the Central Bank to regularly supervise 1,500 rural banking offices (head offices and branches) is limited due to manpower constraints. The costs of supervising and examining rural banks are enormous relative to the rural banks' small share of savings and loans in the entire banking system. Thus, the need for effective internal regulations and supervision in rural banks is very obvious.

2.5.2 Internal regulation and supervision mechanisms

Rural Bank of Panabo has introduced a series of internal regulation and supervision mechanisms that are based on the Rural Banking Act and the Central Bank's regulations.

- Security devices for cash department: On a normal business day, tellers may hold a maximum amount of cash US\$7,680. Should cash holdings exceed that level, RBP calls on one of the depository banks to collect the surplus amount. The branch cashier is responsible for the implementation of these security devices in the bank's branches. The central office is protected by two plainclothes security guards, who simultaneously act as drivers and janitors. The bank is connected via radio with the police station.
- Reporting system to stockholders: Every third Saturday in February, the annual stockholders' meeting provides the bank's shareholders with comprehensive information on the bank's operations, performance and future outlook. Beyond that, no additional information is presented to stockholders, e.g., in the form of a newsletter.
- Internal procedures related to cash transactions: RBP applies a "dual control system", which means that the work of one person must be verified by a second person to determine that proper authority has been given to handle the transaction and that the transaction is properly recorded. Thus, two officers must sign all cash transactions. At the

end of the day, the tellers countercheck their cash balances. In addition to the "dual control system," the bank also applies the "joint custody approach." This approach requires that the processing of certain transactions, like opening and closing of the vault, must be under direct observation of a second person who is equally accountable for the proper handling of the specific operation.

- Internal auditing department: RBP has only recently set up an internal auditing department. All loan releases pass the audit department for recomputation and a check for both signature and completeness of documents. With regard to cash operations, the audit department conducts spot cash audits of the tellers' cash holdings. The department also audits all official receipts at the end of the day.
- Fully computerized bank transactions: As the first bank in the community, RBP computerized its transactions in the early 1990s with the installation of FAO's Microbanker software. While computerized transactions may still be prone to manipulations, the way of handling savings and loan operations has been facilitated through automation. This means that possibilities have improved to rapidly monitor, control and audit these transactions.
- Participation in regional or national associations: As already mentioned, RBP is a member of the Rural Bankers Association of the Philippines (RBAP), which is the national body of rural banks. The bank is also represented on a regional level in one of the rural banking system's federations. Both organizations provide training on internal control and auditing to the rural banks on a limited scale.
- Effectiveness of internal regulations and supervision mechanisms: During RBP's 30-year history, there has not yet been a major case of fraud or nepotism. This allows to draw the conclusion that RBP's system of internal regulations and supervision mechanisms is fairly effective. The bank operates according to sound banking practices which are dictated by the Central Bank's regulations, but which the Central Bank often cannot enforce due to a lack of resources.

2.5.3 Lessons learned in external and internal regulation and supervision mechanisms

2.5.3.1 Success factors

External regulations provide a good framework: Although rural bankers often claim to be dissatisfied with the CB regulations (e.g., on possibilities to write off loans), the existing external regulations, the Rural Banking Act and the Central Bank's regulations for rural banks, provide the basic framework for sound banking practices. Financial indicators and ratios to monitor liquidity and risk assets contribute to lowering the risks a bank is naturally exposed to.

Effective internal supervision: Internal regulations of the rural bank complement the external regulations of the Central Bank. In the absence of effective external supervision, internal supervision mechanisms like "joint custody" or "dual control" must ensure that external and internal regulation requirements are met.

2.5.3.2 Limitations and risks

Lacking external supervision. The institutional capacity of the Central Bank has considerably improved over the last years. However, it appears that the resources of the Central Bank are not yet sufficient to effectively supervise the regulations applying to rural banks. Effective supervision by the Central Bank, however, is a major prerequisite of a functioning financial system to protect the public from bank failures and from the loss of depositors' savings. In the case of Rural Bank of Panabo, the internal supervisory system fills the existing gap.

2.5.3.3 Possibilities of replication

Effective internal supervision as sine qua non. In the absence of effective external supervision, it is a sine qua non for rural banks to implement a strong internal system of regulations and control to adhere to sound banking practices. A rural bank operating in isolation from any support institutions will have difficulties succeeding. National or regional associations or alliances with other rural banks are best suited to develop self-imposed restrictions on financial operations and to strictly enforce these measures.

2.6 Cost analysis of savings mobilization

2.6.1 Scope and quality of accounting and cost analysis

Like any other rural bank, Rural Bank of Panabo is required to use and strictly follow the accounting and reporting standards prescribed by the Central Bank. RBP submits a quarterly schedule of savings and time certificate of deposits, and the statement of income and expenses on a quarterly basis. The financial statements are established with the Microbanker software and take into account the Statement of Financial Accounting Standards (SFAS), which have been issued by the Accounting Standards Council (ASC) and approved by the Professional Regulation Commission (PRC).

Cash transactions, i.e. deposits as well as withdrawals, are collected, validated and consolidated in the following steps:

1. The depositor fills in the signature card of the deposit account (once);
2. The client prepares a deposit slip/withdrawal slip for each transaction;
3. The teller records the data with computer, validates and proceeds with cash operation;
4. All transactions are computerized and printed out at the end of the day;
5. Each teller balances the cash account and prepares a proof sheet;
6. All tellers forward a proof sheet with supporting documents to the accounting unit;
7. The accountant prepares general proof sheets for consolidation;
8. The accountant carries forward the data to prepare the daily statement of conditions; and,
9. The accountant prepares a general daily statement of conditions, consolidating the operations of all branches and the head unit.

The Rural Bank of Panabo is not receiving any subsidies.²⁹ Income statements over the years indicate that the bank is in a position to cover administrative costs, provisions, actual capital costs and inflation from the revenues generated through its lending operations. Thus, the bank could be classified as financially sustainable which usually is the highest level in the determination of a financial institution's economic viability. With a return on equity (ROE) of above 30%, the bank could probably attract more private risk capital willing to finance the bank's new investments.

²⁹ Rediscounting facilities provided by Land Bank are not considered to be subsidies.

2.6.2 Methodologies to keep operating and transaction costs low for the financial institution

The high number of daily cash transactions is only manageable due to a functioning computerized system. Rural Bank of Panabo was the first bank in the municipality to introduce the new technology.

Instead of setting up full-blown cost-intensive branches, RBP favors small, fully computerized branches that are run by a minimum of technical staff. These outlets are located in areas with busy economic activities and serve predominantly to mobilize the existing local resources. Thus, operations are mainly limited to cashiering.

The investment in staff training, particularly the tellers, pays off through efficient handling of all cash transactions. A small survey conducted by the researcher on a normal business day revealed that a client, on average, only spends ten minutes in the bank. The good performance is, of course, also largely due to the above-mentioned computer system.

2.6.3 Methodologies to keep transaction costs low for savers

RBP puts strong emphasis on bringing the bank nearer to the clients through its branches. Thus, depositors accessing the branches save opportunity costs due to shorter travel time. These opportunity costs would certainly accrue if only the central office existed.

Compared to government and even commercial banks, depositors are served very quickly by RBP. The number of tellers can be increased from five to eight in times of full business.

Customers who cannot visit the bank during the week because they are not able to afford the shortage in sales, can easily conduct their banking business on a Saturday or Sunday afternoon.³⁰

2.6.4 Lessons learned in the reduction of operating and transaction costs of the financial institution and the savers

2.6.4.1 Success factors

To reduce operating and transaction costs, RBP installed a computerized system that allows more efficient handling of payment transactions and accounting. Small branches with limited functions acquire local savings without the usual high administrative costs involved. Human resource investments contribute to higher staff productivity and more efficient operations. These measures also cut transaction costs for savers, since the banking services are available to the depositors much faster and at almost any time.

A special feature is the mobilization of savings through the organization of self-help groups, which lowers transaction costs both for the bank and the saver. However, due to the relatively low business volume with SHGs, the importance of the collaboration with SHGs for Rural Bank of Panabo is de facto rather low.

³⁰ Maharlika Branch is open weekdays and on Saturdays and Sundays. Carmen Branch is open weekdays and Saturdays only.

2.6.4.2 Limitations and risks

With the exception of the SHG savings approach, the presented possibilities to lower operating and transaction costs require a certain initial investment. It depends on the financial institution and its economic situation whether such investments are feasible or not.

2.6.4.3 Possibilities of replication

Technically, the above-mentioned success factors are replicable. The establishment of a computerized accounting system, the setting-up of small branches and the training of and seminars for staff, especially on a continuous basis could, however, require both extra manpower and additional funds. A financial institution that would like to implement one of these elements could be supported with financial cooperation funds as intelligent subsidies.

2.7 Preliminary assessment of the impact of the financial and economic crisis on Rural Bank of Panabo

2.7.1 General impact on the bank's performance

The economic and financial crisis, which hit the Philippines in late 1997, did not significantly effect Rural Bank of Panabo's operations and financial position. The bank continued its expansion and outreach to new customers in 1998 with the opening of five more branches. Rural Bank of Panabo went into partnership with the 24-branch Network Bank and the 5-branch ProBank.³¹ Customers can now do transactions seven days a week in the group's 25 branches.

The bank reported declining collection rates during the crisis from mostly small borrowers. The decline, however, was considered to be within tolerable levels due to the relative stability of small enterprises. It was once again shown that small enterprises in rural areas are less exposed to the crisis than more urban based and larger enterprises undertaking dollar-denominated lending and property development business.

2.7.2 Impact on savings mobilization

The table below indicates a drop of 4% in the volume of fixed deposits from year-end 1997 to 1998. A few depositors transferred their fixed deposits to other bigger banks as a preventive measure. However, as the increasing number of fixed deposits in 1998 of 14% indicates, this phenomenon did only apply to a few large account holders. Generally, the bank continued its savings drive with increasing numbers of accounts and volumes. The 38% increase in savings volume can be attributed to mostly small depositors in the recently opened five new branches.

The 80% increase in total accounts from 1996-1998 is a strong indicator for the bank's continued expansion despite the deteriorating overall macro-economic environment in general and the strong decline in agricultural output in particular.

³¹ ProBank is a joint venture between Network Bank and the Archdiocese of Kidapawan in North Cotobato, Mindanao.

Table 1: Changes in deposits after the financial crisis

Year-end Deposits	1996	1997	1998
Current and savings accounts	70.3	90.4	124.7
Increase in %		28.0	38.0
Fixed deposits	61.2	87.6	83.5
Increase in %		43.0	-4.0
Total deposits	131.5	178.0	208.2
Increase in %		35.0	17.0
No. of current and savings accounts	10,948.0	15,069.0	20,062.0
Increase in %		38.0	33.0
No. of fixed deposit accounts	529.0	589.0	669.0
Increase in %		11.0	14.0
Total accounts	11,477.0	15,658.0	20,731.0
Increase in %		36.0	32.0

2.7.3 Liquidity management

In all branches, the Bank experienced some unusual deposit movements during the peak of the crisis. As a preventive management measure, liquidity had to be adjusted upwards to a high minimum level of 40% of total deposit liabilities on the arrival of the crisis. Rural Bank of Panabo's experience gained from earlier similar crisis helped to determine at this liquidity strategy. Rising interest rates and dropping demand for loans helped the bank to adapt its liquidity management.

All in all, the bank's strategy to focus on small accounts, to establish credibility in the community, to maintain high liquidity levels and to cautiously expand with credible partners contributed to smoothen the impact of the crisis on the bank's operations and financial position.

3 CONCLUSIONS

No specific savings approach: The case of Rural Bank of Panabo shows that a small financial institution can successfully mobilize savings from a low-income target clientele without having a specific strategy, approach or philosophy towards savings. The RBP has traditionally given priority to credit product development and prudent asset management. Savings are acknowledged as the major instrument to increase the resource base of the bank and to meet clients' needs for easy, accessible, and interest-yielding deposit facilities.

Institutional advantages of rural banks in mobilizing deposits: The strong community orientation and private of the institution suggest that rural banks are an effective type of financial institution to mobilize savings in rural areas. Management, bank staff, shareholders and clients are largely from the same region and know each other well. This is a decisive factor because people only deposit their money in institutions they know and trust. In contrast to financial institutions owned by the public, the private ownership of rural banks' normally ensures at least a certain minimum level of efficiency.

Institutional disadvantages in mobilizing deposits: The relatively small capital base of rural banks in comparison to commercial banks and the nature of their operations with low-income clients requires prudent liquidity and asset management. In the absence of functioning external supervision by the Central Bank, internal regulation and supervision become very important. Without access to an efficient secondary structure or regional support service, there is, however, no built-in mechanism for rural banks that could guarantee the implementation of sound banking practices.

The image of a modern and reliable community based bank: The success of Rural Bank of Panabo in mobilizing deposits appears to be simple. In more than 30 years, the bank has acquired an excellent reputation in the municipality for its sound banking. In times when other banks had to close for a few days due to a run of clients requesting their deposits, RBP's prudent liquidity management allowed it to continue serving its customers. Rural Bank of Panabo is supporting the socio-economic activities of the community, which has further contributed to the excellent reputation and high credibility that the bank enjoys. This positive image not only attracts small deposits below US\$100, but even manages to attract large funds above US\$5,000.

A number of elements are presented below that should be considered by financial institutions that would like to enter into, or improve, deposit mobilization. The elements are addressed to two types of financial institutions:

- Financial institutions of the "rural bank" type (small capital base, community based, privately-run, loan and deposit transactions only); and,
- Financial institutions of any type involved in the mobilization of small deposits (below US\$100).

Elements to be considered by financial institutions of the "rural bank" type:

- Get access to a region-wide or nationwide network: In an increasingly competitive financial market, community-based banks must explore possibilities of access to regional networks in order to provide their customers with possibilities of withdrawing savings from their accounts in other geographic areas of the country.
- Get access to support services: Investments in human resource development, or in product development, are very costly and cannot be covered in the long-term by a single bank with a small capital base. Access to support services is crucial for a bank involved in

microfinance. Regional or national apex organizations or strategic alliances with other financial institutions could provide these services.

- Impose self-regulations: In the absence of effective external supervision, financial institutions such as rural banks should impose self-regulations that can be controlled by secondary structures.
- Maintain a liquidity above the commercial banks' average: Financial institutions with a small capital base engaged in mobilizing microdeposits should maintain a high liquidity ratio. This means maintaining a liquidity at least above the banking industry's average. In the Filipino context, a 20% liquidity ratio for microfinance institutions appears to be sufficient to meet unexpected situations.
- Price savings products above the competitors' rates: In a relatively competitive environment, microfinance institutions should consider offering their customers a savings interest rate above the rate of the competitors. This policy can contribute to increasing the bank's deposits.
- Conduct careful fund management on a daily basis: To satisfy the liquidity needs of a microfinance institution and to improve financial efficiency, the fund monitoring should be done daily. In case of urgent liquidity needs, rapid access to a liquidity pool is very important.
- Conduct careful risk asset management: The composition and performance of the bank's assets should be monitored constantly through the analysis of key ratios, such as the net worth to risk assets ratio and the past due ratio.
- Set up lean branches: Instead of running costly full-blown branches, small outlets managed with minimal staff and computerized accounting systems contribute to lower operating costs. These branches serve primarily to raise local savings in the area. Thus, operations are limited to cashiering only.
- Build up a positive image of the bank in the community: Apart from the actual services provided by the bank to its customers, the image is determined through a series of factors such as the good reputation and credibility of the individual members of the management and of the shareholders. Thus, the selection of the management as well as the broadening of the shareholder base must be done cautiously and should include criteria such as personal integrity.
- Internal supervision as sine qua non: Since external supervisory institutions such as central banks are often not in a position to adequately deal with financial institutions engaged in microfinance, internal regulations and supervisory mechanisms are crucial. Statutes and by-laws should be as clear and precise as possible, regulating at least the composition of capital stock and the meetings of stockholders and the Board of Directors. Internal control mechanisms such as dual control and joint custody should be a matter of course.

Elements to be considered by any financial institution engaged in the mobilizing of small deposits:

- Employ a sufficient number of tellers: Due to the high number of depositors and cash transactions, any financial institution engaged in mobilizing small deposits should employ a sufficient number of tellers to handle the operations efficiently.
- Train tellers and introduce incentive systems: To improve the efficient settling of cash transactions in order to serve the client rapidly and to keep the number of shortages/surpluses to a low level, tellers should be trained adequately. In addition, the introduction of incentive systems, such as shortage allowances, can contribute to further improve staff efficiency.

- Install an effective computerized system: Efficient hardware and software are a prerequisite to cope with the high number of cash transactions. They will lower operating costs and contribute to improving the general management information system of the financial institution.
- Improve service orientation: Customers expect rapid services from a financial institution. In addition to qualified staff and modern technologies, the localities of the bank should have sufficient space and seating possibilities. The extension of banking hours over the weekend is a major step towards realizing the concept of a bank as a service center.
- Adapt to the needs of small depositors: Classic savings products, such as the regular savings account and the time deposit account, should be adapted to the needs of small depositors. This refers especially to the required minimum initial capital to open and maintain a savings account.
- Raffle contests to promote savings: An effective instrument to increase a bank's deposit resources is a raffle contest. They are popular among customers and, in addition to increased deposits, provide publicity for the bank.
- Compulsory membership in a deposit insurance corporation: The advantage for both the bank and the customer that stems from membership in a deposit insurance corporation appears to be evident. In most cases, the insurance corporation will protect at least small depositors.

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5 ANNEXES

5.1 Annex 1: Macroeconomic, financial and social data

	1992	1993	1994	1995
Macroeconomic Data				
GDP (US\$ billion) constant prices 1985=100	27.0	27.2	32.8	31.5
GDP/capita	427	420	496	464
Sectoral distribution of GDP				
• Agriculture/GDP (%)	22	23	22	21
• Industry/GDP (%)	33	34	35	36
• Services/GDP (%)	45	43	43	43
Financial Data				
Av. ann. inflation rate (consumer price) (%)	7.6	9.0	8.0	n.a.
Exchange rate (Peso/US\$)	26.6	26.9	23.4	25.5
M2/GDP (%)	28.3	32.3	35.6	39.6
Gross savings rate (% GDP)	17.4	15.1	17.5	18.1
Av. nom. deposit rate (comm. banks)				
• Savings accounts (%)	10.6	8.3	8.0	8.0
• Time deposits (6 months) (%)	14.0	10.1	11.0	8.9
Av. nom. lending rate (comm. banks) (%)	19.4	14.6	15.0	14.6
Social Data				
Population (million)	65.3	67.0	68.6	70.3
• Rural population (%)		48		
• Urban population (%)		52		
Population/km ²	218	223	229	234

5.2 Annex 2: Institutional data

	12/1994	12/1995	12/1996
General Information:			
Number of branches/agencies	1	1	2
Number of employees	20	23	31
Balance Sheet Structure:			
Assets (US\$)	5,312,607	6,860,823	8,623,787
• Cash	296,747	271,974	438,271
• Financial assets	1,265,694	1,543,688	1,296,246
• Outstanding loans	3,588,522	4,764,106	6,262,191

	12/1994	12/1995	12/1996
• Equity investments	17,094	15,686	15,209
Liabilities (US\$)	4,260,402	5,552,027	6,995,902
• Amounts owed to private customers (deposits)	3,732,900	4,158,785	5,017,579
• Amounts owed to private financial institutions	256,986	1,032,486	1,561,654
Capital/Equity (US\$)	1,053,312	1,303,176	1,677,886
Loan Portfolio:			
Number of outstanding loans	2,751	3,482	6,350
• Female clients	1,245	1,508	2,626
• Male clients	1,247	1,623	2,449
Volume of outstanding loans (US\$)	3,589,444	4,812,158	5,592,993
• Female clients	1,480,521	2,123,190	2,178,694
• Male clients	1,444,012	1,847,340	2,609,822
No. of loans disbursed during the year	3,149	4,275	5,269
Vol. of loans disbursed during the year (US\$)	4,237,984	5,416,190	8,310,024
% of borrowers w/ savings accounts/time deposits	55	51	74
Nominal lending rate (%)	8-30	8-30	8-30
Savings Facilities:			
Number of savings accounts	10,087	10,039	10,848
• Female clients	5,952	5,923	6,401
• Male clients	4,135	4,116	4,447
Vol. of savings accounts (US\$)	2,651,829	2,676,352	2,675,563
• Female clients	1,603,149	1,621,637	1,629,103
• Male clients	1,048,680	1,054,715	1,046,454
Number of time deposits	513	504	529
• Female clients	302	297	312
• Male clients	211	207	217
Vol. of time deposits (US\$)	1,065,998	1,447,114	2,328,326
• Female clients	627,547	870,442	1,373,228
• Male clients	438,451	606,672	955,098
Number of customers with sav. acc./time deposit	10,600	10,543	11,377
No. of opened sav. acc./time dep. during the year	3,498	3,321	5,233
No. of closed sav. acc./time dep. during the year	2,980	3,815	3,899
No. of deposit transactions during the year	80,252	92,831	90,052
No. of withdrawals during the year	114,405	127,736	117,316
% of depositors who are borrowers	55	51	74
Deposit loan ratio (av. ann. value of savings as % of av. ann. outstanding loans)	85	63	51
Nominal deposit rate (savings accounts) (%)	4	4	3
Nominal deposit rate (time deposits) (%)	6.5-16.0	6.5-16.0	6.5-16.0

5.3 Annex 3: Performance indicators

	1994	1995	1996
Operational efficiency:			
1. Av. ann. value of savings acc./av. ann. number of staff	137,754	121,095	99,109
2. Av. ann. number of savings acc./av. ann. number of staff	524	457	387
3. Number of savings acc. opened/av. ann. number of staff	184	151	194
4. Number of savings acc. closed/av. ann. number of staff	157	173	144
5. Ann. value of deposits/av. ann. number of staff	2,715,313	2,569,574	2,231,497
6. Ann. value of withdrawals/av. ann. number of staff	2,668,253	2,538,779	1,929,052
7. Number of deposits/av. ann. number of staff	4,224	4,220	3,335
8. Number of withdrawals/av. ann. number of staff	6,201	5,806	4,345
9. Number of loans disbursed/av. ann. number of staff	166	194	195
10. Value of loans disbursed/av. ann. number of staff	223,051	246,190	307,778
11. Av. ann. number of outstanding loans/av. ann. number of staff	123	142	182
12. Av. ann. value of outstanding loans/av. ann. number of staff	160,980	190,589	192,397
Liquidity:			
13. Av. ann. liquid assets/av. ann. assets (%)	25.7	23.4	20.8
14. Av. ann. liquid assets/short term liabilities (checking + savings acc.) (%)	32.0	34.4	32.2
Risk Assets:			
15. Capital adequacy ratio (v. ann. adjusted capital/av. ann. risk weighted capital) (%)	23.7	22.9	21.8
16. Av. ann. arrears/av. ann. outstanding loans (%)	84.0	85.0	9.2
17. Default rate (loans under litigation/total loans outstanding) ³²	n.a.	n.a.	0.1%
18. Av. ann. capital/av. ann. arrears (%)	350.0	331.0	307.0
19. Ann. provisions for loan losses/av. ann. outstanding loans (%)	0.8	0.9	0.9
Quality of financial intermediation:			
20. Net interest margin ([interest income – interest expenses]/av. ann. assets) (%)	9.8	10.5	11.3
21. Other operating income to total assets (other operating income/av. ann. assets) (%)	1.6	1.5	1.1

³² Loans are considered past due when they are not paid at maturity; past due ratio = (total loans past due+loans under litigation)/total loans outstanding.

	1994	1995	1996
22. Spread (net interest margin + other operating income margin) (%)	11.4	12.1	12.4
23. Administrative costs/av. ann. assets (%)	5.8	4.7	5.6
24. Provisions for loan losses/av. ann. assets (%)	0.6	0.6	0.7
25. Net utility margin (spread - [adm. costs + loan provision costs]/av. ann. assets) (%)	5.0	6.7	6.1
26. Interest income from lending/av. ann. outstanding loans (%)	23.2	22.1	24.9
27. Interest expenses/av. ann. outstanding loans (%)	8.6	5.8	9.4
28. Interest rate spread (26.-27.) (%)	14.6	16.4	15.4
Profitability:			
29. Return on assets (net income before tax/av. ann. Assets) (%)	6.8	7.2	7.0
30. Return on equity (net income before tax/av. ann. Capital) (%)	35.2	37.2	36.7